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MACROCOSM

From March Badness to a Monday Miracle

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Donald Luskin

No, Wisconsin! But how about the market's reaction to that bad miss on March jobs?

OK, we admit it. Our bracket didn't have Duke winning the NCAA championship, or even going to the final with Wisconsin (nor did Barack Obama's, but Mitt Romney's did). Now on to more important matters.

Yesterday, in the face of a bitterly disappointing payroll jobs report released on a holiday Friday (see "On the March Jobs Report" April 3, 2015), the S&P 500 actually rallied far more than the 13.62 points that will be recorded in the history books. *The index in fact rallied 32.72 points, based on the sharply lower close on the index futures Friday morning after the report.*

- The consensus explanation is that "bad news is good news," because this jobs miss could defer the day of the Fed's "liftoff" from the zero bound on the funds rate. Indeed, an hour before stocks opened yesterday New York Fed President William Dudley gave a seemingly reassuring speech.
- He said liftoff would occur "if…labor market improvement continues" -- which, arguably, it is now not doing. He noted, as we have on many occasions, that liftoff "will simply be moving from an extremely accommodative monetary policy to one that is slightly less so." He said, just as Chair Janet Yellen first said last December (see "On the December FOMC" December 17, 2014), and repeated in a speech the week before last, that the "path of short-term rates after lift-off…will be relatively shallow." And he pointed out that, in his view "the long-run nominal federal funds rate consistent with 2 percent inflation is…3½ percent" -- as the FOMC's "dots" have been telling us for many months (see "The Fed's Growth-Friendly 'Dot' Gap" September 19, 2014).
- *In short, Dudley said nothing new whatsoever.*

What's new was the announcement overnight that Saudi Arabia has raised its crude prices to Asia for the second month in a row, reportedly citing improved refining margins and a pick-up in global demand in response to lower prices.

- Obviously, anything that relieves the relentless fear of slowing Asian growth is especially positive for sentiment.

Update to strategic view

US STOCKS, OIL, US MACRO, US FED, FX: Considering futures markets on the Friday holiday, yesterday the S&P 500 rallied 32.72 points, not the 13.62 that showed on the tape, despite Friday's big miss on jobs. Dudley made reassuring noises, but we think the explanator is the sharp rally in global crude prices despite the risk of new supplies from Iran. Saudi announced a price hike on improved global demand, reaffirming our view that we've seen the lows for the year in crude -- and by extension, the highs for the dollar. This reduces the risk of recession, and a potential "reflexive" vicious cycle, arising from the shock of fracking as a "disruptive technology." Stocks have corrected only 3.28%, so it's hard to believe we've seen the worst in this move. But the fundamentals are all falling into place for a move back to the highs.

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- *But more important, we note that global crude prices rose more than 5% yesterday on the Saudi news. The concurrent rise in stock prices and oil prices suggests to us that, while lower oil prices surely enable faster growth, what's most important now is a reliable end to crude's destabilizing fire-sale cascade -- and end we predicted in mid-January* (see "Oilmageddon: The Sequel" January 15, 2015) *-- and the interconnected rally in the US dollar*.
- This move by Saudi implies that at least its contribution to the crude cascade is over, having stood by passively while prices collapsed, in single-minded pursuit of recapturing lost market-share (see "Saudisfaction Guaranteed" March 13, 2015).
- Saudi's move, and oil's response to it, comes on the heels of pretty much no market response at all to the announcement Thursday of "parameters" for a "plan" to contain Iran's nuclear weapons development. No sooner were the "parameters" announced than Iran's foreign minister disputed US claims about them -- so it's not at all clear that an actual deal will ever be struck. But if one is, the elimination of Western sanctions could lead to about a million barrels/day of Iranian oil unleashed on the global market. It's a reassuring sign of strength for oil that this possibility wasn't in the least destabilizing.
- The soft-spot in growth in Q1 is surely the result of the negative externalities of crude's decline since June, including the interconnected rally in the US dollar. Horizontal drilling and hydraulic fracturing have proven to be "disruptive technologies." It's as though the traditional energy economy were taxi drivers, and fracking is Uber (see, originally, "Oilmageddon" December 16, 2014).
- *However positive that will turn out be in the long run, we have worried that in the short run this disruption could tip the economy into recession* (see "Houston, You're the Problem" March 9, 2015).
- *If that happens, there's the possibility that the recession would be subject to the vicious cycle dynamics of "reflexivity." In a recession, demand would fall and oil prices would be driven lower, deepening the disruption that caused the recession in the first place, in turn deepening the recession, and in turn driving oil prices lower still, and so on.*
- The safety valve is demand for oil, which ought to come into play as prices fall, supporting prices on the one hand, and powering economic growth on the other hand. This is not straightforwardly a symmetrically reflexive dynamic, because at some point the higher oil prices resulting from faster growth act as a brake on growth. So the result is not a virtuous cycle, but rather an equilibrium.
- But that more optimistic scenario will take place in a new world for energy, in which fracking enables supply to increase to meet demand more flexibly that it ever has before. We know, for example, that there are hundreds of uncompleted wells waiting to be fracked as soon as oil hits $65 (see "I Have Seen the Future, and It Fracks" February 24, 2015).
- *So the equilibrium between growth and crude prices that will be reached now will be a more growth-friendly one than was possible before, when oil was a "scarcity good" rather than an "abundance*

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FT BeyondBrics
March 26, 2015

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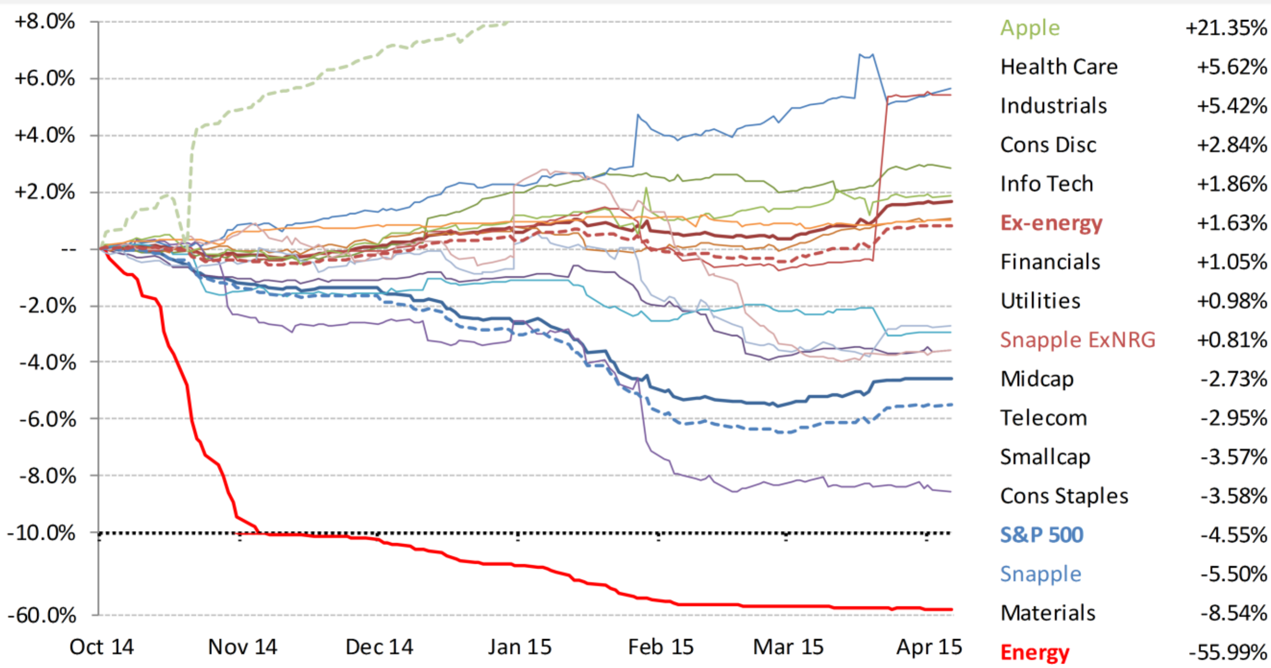
<u>good." In other words, more growth will be possible at a given crude price. Or to put it another way, unit energy costs will go down, enabling the economy to profitably become more energy-intensive</u> (see ["Don't Let a Good Oil Crisis Go to Waste"] October 21, 2014).

Further evidence that the worst of the oil-shock may be over is a potential reversal of the rollover of S&P 500 forward earnings that began early last October (please see the chart below).

- When we looked last month (again, see ["Houston, You're the Problem"]), S&P 500 forward earnings were off 5.38%. Today, though energy sector earnings have continued to fall, overall forward earnings are now off only 4.55%.
- *Ex-energy, forward earnings a month ago were up a paltry 0.56% over five months. Today, with six months passed, they are up 1.63%. <u>There's nothing especially encouraging about upgrades of only 1.63% over six months -- but it is encouraging to see upgrades improve by 1.07% over just one month.</u>*
- About 40% of that gain comes from the elimination in the S&P 500 Index two weeks ago of Allergan, and its replacement by American Airlines, a company with greater aggregate earnings. Even abstracting from that, the upgrade rate has nevertheless noticeably improved. Besides, index member changes happen all the time, and are part of the normal background noise in the calculation of aggregate forward earnings, which we have long found to be a reliable business cycle indicator.
- Further, we think it matters that the improvement ex-energy has

Forward earnings Percentage change from October 1, 2014 *"Snapple" is S&P 500 with no Apple*



Source: Bloomberg, TrendMacro calculations

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come at the same time as continued disimprovement in the energy sector. That implies a potential decoupling of energy and the rest of the economy -- that is, the ex-energy economy has potentially maxed out the pain it can experience radiating from the energy sector.

- Now let's say that oil prices continue to improve -- and better yet, that the spread between West Texas Intermediate (the US benchmark) narrows versus Brent (the global benchmark) as we predicted two weeks ago (see "Domestic Crude: Getting More Refined" March 26, 2015). Then we'd be looking at a situation in which energy sector forward earnings will start getting upgraded, joining up with the rest of the economy.

With stocks having corrected at most only 3.28% over the last several weeks -- from all-time highs, and after not having had a 10% correction in 34 months -- and with an 11-year high forward price/earnings multiple of 17 -- it's very difficult for us to say with confidence that we've seen the worst in this move.

- *But we like what we see. The ground is getting prepared for a move back to the highs.*
- We like that bad data shocks like Friday's jobs report are focusing the consensus on the blow to growth we'd been talking about for quite a while already
- We like that oil is stabilizing even in the face of the threat of new supply from Iran, and that Saudi feels confident enough about demand to raise prices.
- We like that ex-energy S&P 500 forward earnings have been getting upgraded aggressively over the last month, even while energy earnings continue to be moderately downgraded.
- And while we find nothing new in Fedspeak, we're glad that officials are now talking not just about liftoff, but about what really counts -- the path of short-terms rates, and its predicted below-normal value even when the economy is back to normal.

Bottom line

Considering futures markets on the Friday holiday, yesterday the S&P 500 rallied 32.72 points, not the 13.62 that showed on the tape, despite Friday's big miss on jobs. Dudley made reassuring noises, but we think the explanator is the sharp rally in global crude prices despite the risk of new supplies from Iran. Saudi announced a price hike on improved global demand, reaffirming our view that we've seen the lows for the year in crude -- and by extension, the highs for the dollar. This reduces the risk of recession, and a potential "reflexive" vicious cycle, arising from the shock of fracking as a "disruptive technology." Stocks have corrected only 3.28%, so it's hard to believe we've seen the worst in this move. But the fundamentals are all falling into place for a move back to the highs.